DEPARTMENT OF STATE REVENUE
Letter of Findings: 01-0027
Special Corporation Income Tax
For the Tax Periods Ending 1997, 1998, and 1999

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax – Disallowed Business Expense Deductions.

Authority: IC 6-8.1-5-1(b); IC 6-8.1-5-1(c); I.R.C. § 105; I.R.C. § 162; American Foundry v. Commissioner, 536 F.2d 289 (9th Cir. 1976); Chism's Estate v. Commissioner, 322 F.2d 956 (9th Cir. 1963).

Taxpayer argues that the audit erred in disallowing certain business expense deductions claimed by the taxpayer.

II. Notice of Resolution.

Authority. IC 6-8.1-3-17; IC 6-8.1-5-2(a).

Taxpayer maintains that the Department of Revenue (Department), having erroneously issued a Notice of Resolution for taxpayer's 1999 liabilities, absolved the taxpayer from any additional tax liabilities for the tax periods ending in 1997, 1998, and 1999.

III. Abatement of the Ten-Percent Negligence Penalty.

Authority. IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c); I.R.C. § 162.

Taxpayer argues that the audit was without basis in deciding to impose the ten-percent negligence penalty.

FACTS

Taxpayer is an automobile dealership reporting its income as an Indiana special corporation. The audit examined the taxpayer's Special Corporation Tax Returns for the tax periods ending in 1997, 1998, and 1999. The audit found that taxpayer's adjusted gross income calculation was based on its federal taxable income as adjusted for Indiana modifications. In reviewing

taxpayer's federal returns, the audit disallowed certain of taxpayer's claimed business expenditures. The disallowed expenditures related to reimbursements made to taxpayer's primary shareholder. The audit disallowed payments made to reimburse primary shareholder for medical and credit card expenditures. Thereafter, the audit assessed taxpayer for additional income taxes for the three tax periods.

On December 27, 2000, the Department received taxpayer's protest of the audit's determinations. On March 27, 2001, the Department sent taxpayer a "Notice of Resolution." In that notice, the Department stated that, "Your recent explanation and/or payment with respect to the notice previously mailed to you is satisfactory. No further action is required on your part." In effect, the notice purportedly absolved taxpayer of the additional assessment for one of the three tax periods, the period ending in 1999. The Department later determined that the Notice of Resolution was erroneously issued.

Taxpayer pursued its original protest. An administrative hearing was held, and this Letter of Findings followed.

DISCUSSION

I. Adjusted Gross Income Tax – Disallowed Business Expense Deductions.

Taxpayer maintains that the audit erred in disallowing certain of taxpayer's business expenses. Taxpayer asserts that the reimbursements of majority shareholder's expenses were legitimate business expenses and should not have been disallowed.

During a portion of the year, majority shareholder lived at an out-of-state location. The taxpayer reimbursed the majority shareholder for certain of majority shareholder's out-of-state expenses including medical and drug costs, payments for health and life insurance, equipment costs, and utility expenses. The audit determined that some of the expenses were majority shareholder and his spouse's personal expenses. Accordingly, the audit disallowed those expenses which it determined were "personal."

In effect, taxpayer's maintains that the disbursements made to majority shareholder were ordinary and necessary business expenses. Under I.R.C. § 162:

> (a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including --
>
> > (1) a reasonable allowance for salaries or other compensation for personal services actually rendered;
> >
> > (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Taxpayer places special emphasis on the payment of majority shareholder's medical expenses arguing that these reimbursements constituted a medical reimbursement plan. In support of that assertion, taxpayer cites to I.R.C. § 105. However, there is no indication in either I.R.C. § 105 or I.R.C. § 162 that qualifying medical payments can be made on an ad hoc basis or pursuant to a post facto plan. American Foundry v. Commissioner, 536 F.2d 289, 293 (9th Cir. 1976); *See also* Chism's Estate v. Commissioner, 322 F.2d 956, 961 (9th Cir. 1963).

Taxpayer has presented nothing to indicate that the reimbursements for medical expenses constituted a "reasonable allowance for salaries or other compensation" or that the reimbursements were made in accordance with a reciprocal agreement for "personal services actually rendered." In addition the courts have determined that a "plan" is a necessary precondition to the operation of I.R.C. § 105. American Foundry, 536 F.2d at 294. As that court stated, "To allow otherwise would permit a close corporation to transfer, tax-free, significant dividends in the form of health, welfare, and disability payments to stockholders, without meaningful reference to their role as employees." Id.

Taxpayer is, of course, free to make whatever payments it wishes to majority shareholder. However, absent any indication that reimbursement of majority shareholder's medical expenses was made pursuant to a health plan, that they were made in return for personal services actually rendered, or that the reimbursements were made as part of majority shareholder's compensation, the reimbursements do not fall within the purview of I.R.C. § 162 as deductible business expenses.

Taxpayer implies that the Department is required to sort through taxpayer's numerous transactions and to demonstrate which of its expenses are "non-business" expenses. Taxpayer errs. The requirements for establishing a "business expense" under I.R.C. § 162 are specifically drawn and it is the taxpayer – being most familiar with its own business practices – which is in the best position of making those determinations and thereafter providing a substantive basis for those determinations. Specifically, IC 6-8.1-5-1(b) provides that "[t]he burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Although IC 6-8.1-5-1(c) requires that the Department provide the taxpayer a venue in which to protest the classification of its expenses and the consequent assessments, in this instance taxpayer failed to take full advantage of that opportunity and has provided no basis upon which to determine the classification of the expenses or the additional assessments were incorrect.

FINDING

Taxpayer's protest is respectfully denied.

II. Notice of Resolution.

Taxpayer argues the Department's erroneously issued March 27, 2001, "Notice of Resolution" absolved it from further responsibility for the assessments audit imposed for the tax periods ending 1997, 1998, and 1999. The unsigned Notice of Resolution states:

> Your recent explanation and/or payment with respect to the notice previously mailed to you is satisfactory. No further action is required on your part. However, you may still be responsible for any liabilities during the period ending 09/30/1999 proven to be owed by you at a later date. We appreciate your cooperation in this matter.

The letter is addressed to taxpayer, references specifically one of the three tax periods examined during the audit, and was issued some three months after the Department received taxpayer's original protest letter.

Although, the language contained within the Notice of Resolution can be fairly interpreted as a response to taxpayer's original protest letter, there is no merit in taxpayer's suggestion that the letter impliedly absolved taxpayer from liability for 1997 and 1998. There is no indication that the Notice of Resolution was the product of fraud or duplicity. In addition, the Department was acting with its express statutory authority to settle the disputed tax issue once taxpayer had placed that issue under protest. IC 6-8.1-3-17.

However, a notice of "Proposed Assessment" was prepared and issued by the Department on March 4, 2002. That notice informed the taxpayer that it owed additional income taxes for the tax period ending in 1999. The notice informed the taxpayer that it owed additional income taxes in an amount equal to the assessment originally imposed by the audit.

The March 4 notice was issued within the time limitations established under IC 6-8.1-5-2(a). The statute establishes the limitations period as follows: "Except as otherwise provided in this section, the department may not issue a proposed under section 1 of this chapter more than three (3) years after the latest of the date the return is filed, or any of the following: (1) the due date of the return of the return. . . ."

Taxpayer's original 1999 return was due on January 15, 2000. Therefore, under IC 6-8.1-5-2, the Department had until January 15, 2003, in which to issue an additional assessment. The March 4, 2002, notice fell well within the statutory time limitation and had the effect of "reviving" the assessment of additional taxes owed for the 1999 tax period.

FINDING

Taxpayer's protest is respectfully denied.

III. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer argues that the audit acted capriciously in imposing the ten-percent negligence penalty.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Department regulation 45 IAC 15-11-2 provides guidance in determining if the taxpayer was negligent.

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer issued seemingly undifferentiated reimbursements for personal expenses incurred by majority shareholder and then claimed those reimbursements as business deductions. Taxpayer is a substantial and sophisticated business entity fully capable of understanding that deductible business expenses are specifically limited to those "ordinary and necessary expenses paid or incurred . . . in carrying on [its] trade or business" including compensation for "personal services actually rendered." I.R.C. § 162.

FINDING

Taxpayer's protest is respectfully denied.

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